

**APPEALS**  
**INDUSTRY SPECIALIZATION PROGRAM**  
**COORDINATED ISSUE PAPER**

**INDUSTRY:** Forest Products

**ISSUE:** Depreciation - MACRS Class Lives of Steam Systems and Electric Generation & Distribution

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**APPROVED:**

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WESTERN REGION

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DATE

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## SETTLEMENT POSITION

### Depreciation - MACRS Class Lives of Steam and Electric Generation and Distribution Systems

#### STATEMENT OF ISSUES

- (1) What are the proper class lives to be used in computing depreciation on steam and electric generation and distribution systems used in the forest products industry?
- (2) What should be included in the steam and electrical distribution system contained in Asset Class 00.4?

#### EXAMINATION DIVISION POSITION

The large steam and electric generation and/or distribution systems used primarily in the business activities (asset classes 24.1 - 26.2) relating to the forest products industry are described in Asset Class 00.4 and are classified accordingly. The principal exceptions are chemical recovery boilers used by the pulp and paper industry, smaller systems that do not meet the capacity requirements specified in Asset Class 00.4, and boilers used to generate electricity that meet the definition of a qualifying small power production facility.

#### DISCUSSION

##### Background:

This Appeals position paper deals with certain steam and electric generation and distribution equipment used in the forest products industry. The following types of property are considered:

<u>Type</u>	<u>Reference</u>	<u>Conclusion</u>	<u>Code/Asset Class Recovery Period</u>	
1. Small Capacity Electric/Steam Facilities (500 kilowatts and/or 12,500 lbs. per hour, or less)	24.2,-.4		26.1	7 Years
2. Steam and Chemical Recovery Boilers used to Recover Chemicals used in Manufacturing, other than those qualifying under item #5	26.1	7 Years		
3. Fossil Fuel Boilers (Coal, Oil, or Natural Gas), other than those qualifying under item No. 1	00.4	15 Years		
4. Hog Fuel Boilers (Waste Wood, Sawdust, and Bark), other than those qualifying under item No. 1	00.4			15 Years
5. Qualified Small Power Production Facilities	§168(e)(3)(B)(vi)(II)	5 Years		
6. Electric Generation and Electric and Steam Distribution Systems	00.4	15 Years		

Items 1, 2, and 3 are non-controversial and should be assigned recovery periods as indicated. If controversies regarding these types of assets are encountered, the Appeals Forest Products Industry Coordinator should be consulted.

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The controversy then, and the focus of this position paper is on items:

- 4) Hog Fuel Boilers in excess of the capacities stated at 1.
  - ◆ Some taxpayers attempt to classify these assets under Asset Class 49.5 "Waste Reduction and Resource Plants" with a 7-year recovery period.
- 5) Qualified Small Power Production Facility
  - ◆ Some taxpayers attempt to include Biomass (Hog Fuel) boilers which do not produce electricity in the 5-year recovery period of this definition rather than the 15-year recovery period of Asset Class 00.4.
- 6) Electric Generation and Electric and Steam Distribution Systems
  - ◆ Some taxpayers attempt to include these assets in asset classes other than 00.4 with recovery periods shorter than 15 years.

Section 168 provides the general rules for determining the amount of depreciation deductions for the property in question which was placed in service after 1986 (or after 7/31/86 if elected by the taxpayer). Section 168 provides for the depreciation method, the recovery period, and the applicable convention. Sections 168(c) and 168(e) provide that the recovery period is determined by the property's "class life". Section 168(i)(1) specifies the "class lives" for property except where otherwise provided in Section 168.

Revenue Procedure 87-56, 1987-2 C.B. 674 (clarified and modified by Revenue Procedure 88-22, 1988-1 C.B. 785), contains the prescribed asset class lives and applicable recovery periods. This position paper principally addresses the proper asset classification of hog fuel steam and electrical generation and distribution systems.

### Law and Argument RE: Item 4, Hog Fuel Boilers (Not Qualifying as Item 5)

Revenue Procedure 87-56, under a section entitled "Specific Depreciable Assets Used in All Business Activities, Except as Noted", includes Asset Class 00.4, which reads as follows:

#### **Industrial Steam and Electric Generation and/or Distribution Systems:**

Includes assets, whether such assets are section 1245 property or 1250 property, providing such assets are depreciable, used in the production and/or distribution of electricity with rated total capacity in excess of 500 Kilowatts and/or assets used in the production and/or distribution of steam with rated total capacity in excess of 12,500 pounds per hour for use by the taxpayer in its industrial manufacturing process or plant activity and not ordinarily available for sale to others. Does not include buildings and structural components as defined in section 1.48-1(e) of the regulations. Assets used to generate and/or distribute electricity or steam of the type described above but of lesser rated capacity are not included, but are included in the appropriate manufacturing equipment classes elsewhere specified.

Also includes electric generating and steam distribution assets, which may utilize steam produced by a waste reduction and resource recovery plant, used by the taxpayer in its industrial manufacturing process or plant activity. Steam and chemical recovery boiler systems used for the recovery and regeneration of chemicals used in manufacturing, with rated capacity in excess of that described above, with specifically related distribution and return systems are not included but are included in appropriate manufacturing equipment classes elsewhere specified. An example of an excluded steam and chemical recovery boiler system is that used in the pulp and paper manufacturing industry. (underlining supplied).

Thus, where a hog fuel boiler system produces and distributes electricity or steam for use in the taxpayer's manufacturing plant and the system exceeds the stated capacities, we would expect the hog fuel boiler to be classed as a 00.4 asset with a resultant recovery period of 15 years. However, the description of that asset class

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also specifically states that electric generating and steam distribution assets which use steam produced by a waste reduction plant used by the taxpayer in its manufacturing plant is also a class 00.4 asset. Some taxpayers argue that this latter phrase indicates that where the steam is produced in a "waste recovery plant", only the electric generation and steam distribution assets are included in asset class 00.4 with the result that the boiler (the steam production asset) should be included in asset class 49.5, Waste Reduction Plants, with a recovery period of 7 years.

This argument is faulty because the statement on electric generating and steam distribution assets using steam from a waste reduction plant is inclusionary and not exclusionary. That statement merely includes the electric generating and steam distribution assets of a waste reduction plant in asset class 00.4. It does not preclude inclusion of a hog fuel boiler in asset class 00.4 if it meets the specifications in the first sentence of the description for that asset class.

Asset Class 49.5 from Revenue Procedure 87-56 is as follows:

### **Waste Reduction and Resource Recovery Plants:**

Includes assets used in the conversion of refuse or other solid waste or biomass to heat or to a solid, liquid, or gaseous fuel. Also includes all process plant equipment and structures at the site used to receive, handle, collect, and process refuse or other solid waste or biomass to a solid, liquid, or gaseous fuel or to handle and burn refuse or other solid waste or biomass in a waterwall combustion system, oil or gas pyrolysis system, or refuse derived fuel system to create hot water, gas, steam and electricity. Includes material recovery and support assets used in refuse or solid refuse or solid waste receiving, collecting, handling, sorting, shredding, classifying, and separation systems. Does not include any package boilers, or electric generators and related assets such as electricity, hot water, steam and manufactured gas production plants classified in classes 00.4, 49.13, 49.221, and 49.4. Does include, however, all other utilities such as water supply and treatment facilities, ash handling and other related land improvements of a waste reduction and resource recovery plant. (underlining supplied).

The first two sentences of this description would appear to include a hog fuel boiler as it converts refuse and/or biomass to heat by burning it to create steam and electricity. However, the fourth sentence clearly removes a hog fuel boiler from this category as it is stated there that 49.5 does not include steam plants classified in 00.4.

Additionally, it should be noted that between asset classes 48.45 and 49.11 in Revenue Procedure 87-56, is what appears to be a "heading" for all of the asset class 49 items. That heading is as follows:

### **Electric, Gas, Water and Steam, Utility Services:**

Includes assets used in the production, transmission and distribution of electricity, gas, steam, or water for sale including related land improvements. (underlining supplied)

Thus, it would appear that the class 49 assets as listed apply only to assets producing electricity and steam for sale to others. This is consistent with the industry classifications in the Standard Industry Classification Manual, 1987, issued by the Executive Office of the President. The Industry Group 49 in the manual includes only utilities with electric, gas, and steam services for sale. This being the case, asset class 49.5 would not apply to hog fuel boilers used in the forest products industry as those assets are used to generate power for the taxpayer's manufacturing activities as specified in 00.4.

### **Law and Argument RE: Item 5, Qualifying Small Power Production Facility**

An exception to the class lives prescribed by Rev. Proc. 87-56 is contained in Code Section 168(e)(3)(B)(vi)(II). That section provides for a 5-year recovery period for biomass property which is a "qualifying small power production facility within the meaning of Section 3(17)(C) of the Federal Power Act (16 U.S.C. 796 (17)(C), as in effect on September 1, 1986)". Pertinent portions of that Section are attached for reference at Exhibit A.

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Code Section 168(e)(3)(B)(vi)(II) refers only to section 796(17)(C) of the Federal Power Act, and that section by itself does not refer to any requirement for the Biomass facility (including one using waste biomass) to produce electricity. Some taxpayers, therefore, conclude that their hog fuel boilers producing steam (but not electricity) for use in their facilities have a 5-year recovery period. Section 796(17)(C), however, merely defines a "qualifying small power production facility" to be a small power production facility that the [Federal Power] Commission determines meets the requirements (such as fuel use and efficiency) as the Commission prescribes and is not owned by a person primarily engaged in the generation and sale of electric power. Section 796(17)(A) defines "small power production facility" to be a facility that produces from biomass (and other specified sources) electric energy, and the facility has a power production capacity of not greater than 80 megawatts.

It becomes obvious on reading the pertinent sections of the Federal Power Act that a qualifying small power production facility must produce electric energy. Thus, hog fuel and chemical recovery boiler systems that produce steam but not electricity are not qualifying small power production facilities.

### Law and Argument RE: Item 6, Electric Generation and Electric and Steam Distribution Systems

It should be noted that electric and steam distribution systems (as opposed to the boilers) are not excepted out of 00.4 assets, except for those associated with chemical recovery boilers. The electric generating and steam distribution systems are specifically included in Class 00.4 for waste reduction and resource recovering plants. The electrical generation and electric and steam distribution assets of a Qualified Small Power Production facility are not part of the 5-year recovery property because Section 168(e)(3)(B)(vi)(II) requires the property to qualify under Section 48(l)(15) and that section refers to Section 48(l)(3)(A)(i) through (iii) which includes only boilers, burners, and fuel conversion systems (not electric generation and electric and steam distribution systems).

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## Exhibit A

[Title 16 U.S.C. at 796 provided on September 1, 1986, in pertinent part:]

### 796. Definitions

The words defined in this section shall have the following meanings for purposes of this Chapter, to wit:

[AND, at (17), provided:]

17(A) "small power production facility" means a facility which --

- (i) produces electric energy solely by the use, as a primary energy source, of biomass, waste, renewable resources, geothermal resources or any combination thereof; and
- (ii) has a power production capacity which, together with any other facilities located at the same site (as determined by the Commission), is not greater than 80 megawatts;

(B) "primary energy source" means the fuel or fuels used for the generation of electric energy, except that such term does not include, as determined under the rules prescribed by the Commission, in consultation with the Secretary of Energy--

- (i) the minimum amounts of fuel required for ignition, startup, testing, flame stabilization, and control uses, and
- (ii) the minimum amounts of fuel required to alleviate or prevent--
  - (I) unanticipated equipment outages, and
  - (II) emergencies, directly affecting the public health, safety, or welfare, which would result from electric power outages;

(C) "qualifying small power production facility" means a small power production facility-- (underlining supplied, this phrase requires an apparent reference back to (17)(A) for definition of "small power production facility")

- (i) which the Commission determines, by rule, meets such requirements (including requirements respecting fuel use, fuel efficiency, and reliability) as the Commission may, by rule, prescribe; and
- (ii) which is owned by a person not primarily engaged in the generation or sale of electric power (other than electric power solely from cogeneration facilities or small power production facilities) ...